

San Francisco calls a CMRS customer in Eureka (300 miles away), today the Pacific Bell subscriber pays no additional charges for the call.

This type of pricing to end users is possible only because our interconnection arrangements are based on the access charge structure, in which we charge CMRS providers for both the origination and termination of their calls. For instance, in the San Francisco to Eureka example, the CMRS provider pays Pacific Bell an average of 2.0 cents per minute of use for completed calls only. Those per minute charges to CMRS providers currently compensate us for our costs and partially make up the revenue shortfall that we otherwise would experience from providing our end users with LATA-wide termination to CMRS customers at low, flat rates, as requested by CMRS providers.

It should be noted that end user pricing for airtime on CMRS providers' services is based on both "originating party pays" and "called party pays." That is, the CMRS providers, not the LECs, receive the end user compensation for the CMRS calls, regardless of whether the LEC originates or terminates them. Therefore, we currently are in the position of an access provider, and must rely on charges for origination and termination of the calls in order to recover our costs.

If the Commission ordered Bill and Keep, we would stop receiving access charge-based compensation for originating and terminating the CMRS providers' calls. This would create a huge shortfall in our current cost recovery. The Commission states that LECs could make up this shortfall from their own subscribers, but provides no

guidance on how LECs might do that.⁴⁴ To recover some of the shortfall, we would need to revise our charges to our end users so that they no longer could make LATA-wide calls to CMRS end users without charges above flat-rate local service. Indeed, they might need to be charged a premium on those calls.⁴⁵

Even when we change to a Mutual Compensation arrangement, we will face a cost-recovery shortfall, unless we adjust end user rates. With Mutual Compensation, we will pay CMRS providers directly for terminating calls, rather than being paid for originating and terminating the calls. Moreover, they will be paying us to terminate far fewer calls than we will be paying them to terminate. This will introduce new costs and create a large shortfall in our cost recovery. Thus, we will need to revise the charges to our end users so that they pay compensatory rates for calls to CMRS customers.

We cannot quickly revise how we charge end users for specific calls. Thus Bill and Keep cannot be implemented quickly on an interim basis. In addition, the implementation of Mutual Compensation will take time. Revisions in end user charges require us to take the following steps:

- negotiate new arrangements with CMRS providers;
- gain CPUC approval of the arrangements and any changes in end user charges;
- obtain and install software translations in our switches;⁴⁶

⁴⁴ NPRM, para. 62.

⁴⁵ For example, every Pacific Bell call to a wireless NXX could be billed as toll, mileage band 1.

⁴⁶ Special toll-type rates may be needed to bill wireline end users when they are calling wireless end users. For that, we would need translations work in our switches to create a recording on local calls.

- unbundle charges for parts of our network in cases where CMRS providers currently have chosen to purchase services on a bundled basis;⁴⁷
- provide notice to end users;
- modify our billing system to handle price changes.

All the costs left uncovered by Bill and Keep could not reasonably or readily be recovered from our end users. Cost causers should pay for the recovery of costs. Our end users are not causing all the costs and should not shoulder all the burden. Moreover, as Commissioner Ness stated, "a strict regulatory prescription for an interconnection rate of zero represents a stronger exercise of regulatory power than is common, even for pricing of LEC services."⁴⁸ Indeed, requiring Bill and Keep with an interconnection rate of zero and without establishing a cost-recovery mechanism would be inconsistent "with meeting 'the minimal requirements for protection of investors' against confiscation that inhere in the statutory standard of just and reasonable rates."⁴⁹

CMRS providers can prosper under Mutual Compensation arrangements. With Mutual Compensation overlaid on "called party pays," CMRS providers will be paid both by their own CMRS end users and by us when they terminate calls that originate on the

⁴⁷ For instance, Pacific Bell offers a tandem 2A blended arrangement in which the usage rate includes recovery of the cost of the digital facility. Thus, the usage rate is higher than the rate for usage charged when a separate dedicated 1.544 High Capacity facility is separately billed at a flat rate.

⁴⁸ Separate Statement of Commissioner Susan Ness, pp. 1-2.

⁴⁹ See Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Further Notice of Proposed Rulemaking ("Price Caps FNPRM"), 3 FCC Rcd 3195, para. 319, citing Jersey Cent Power & Light v. FERC, 810 F.2d 1168, 1177 (D.C. Cir. 1987) (quoting Washington Gas Light v. Baker, 188 F.2d 11, 15 (D.C. Cir. 1950), cert. denied, 340 U.S. 952 (1951)).

landline network. Certainly, CMRS providers will recover all their costs in this arrangement, and we must be allowed the opportunity to recover our costs as well.

The appropriate cost standard for use in developing the price floors for the LECs' interconnection and end user prices is long run incremental cost ("LRIC").⁵⁰ LRIC should be used for LEC price floors because pricing at LRIC does not recover shared and common costs.⁵¹ Drs. Tardiff and Emmerson explain the need for LECs to recover these costs, as follows:

Finally, because local exchange carriers (LECs) are multiproduct firms, their costs depend on the outputs of all products. Because of the existence of economies of scope (fixed costs that are shared by two or more services), the prices of the services that share the fixed costs must exceed incremental cost in order to recover all costs. That is, unlike perfect competition, where prices are driven to cost, telecommunications markets, like most other markets, are imperfectly competitive. Therefore, prices must generally depart from incremental costs, with demand conditions being the primary determinant of the price-cost margin. In particular, interstate access and interconnection rates must be above incremental cost in order to provide LECs with the opportunity to recover all costs. To the extent that access charge and universal service reform shift the recovery of some of these costs to non-traffic sensitive services and/or to a surcharge on the revenues of all providers, rates for particular interconnection elements may be reduced towards incremental cost.

To summarize, with imperfect competition, incremental cost defines the *minimum* price level. Prices themselves will typically be above the minimum, with more price elastic services being closer to the minimum than services that are less elastic. A regulatory regime designed to emulate this

⁵⁰ This is also known as "long run marginal cost." "Incremental Cost Principles For Local Network Interconnection," Timothy J. Tardiff and Richard D. Emmerson, pp. 4, 5, 7, ("Tardiff and Emmerson") attached hereto as Exhibit D.

⁵¹ Hausman Statement, para. 12, attached hereto as Exhibit B.

competitive outcome would use incremental costs to establish *price floors*, not set prices. LECs would then be free to price at or above these floors depending on the market conditions they faced.⁵²

Making the appropriate cost recovery adjustments so that we have the opportunity to recover our total costs will take time. Therefore, these changes would not be appropriate for action on an interim basis.

E. THE COMMISSION AND STATE REGULATORS SHOULD REFORM THEIR ACCESS AND INTERCONNECTION RULES SO THAT ALL PROVIDERS ARE TREATED CONSISTENTLY

We support Mutual Compensation that allows all providers the opportunity to recover their costs when they terminate traffic from another network provider and when they originate traffic from their end users. As discussed above, however, the implementation of Mutual Compensation is currently inconsistent with access charge arrangements. Under access charge arrangements, the carrier that originates and/or terminates traffic for another carrier is compensated by the latter carrier for providing these access services. The carrier providing the access is not compensated by end users for the call and does not pay for the termination of traffic.

The Commission and many state regulators had planned to reform their access and interconnection rules even before passage of the Telecommunications Act of 1996. Under the Act, they must reform many of their local access and interconnection rules.

⁵² Id. at 4-5.

In that reform, the implementation of Mutual Compensation and access charge arrangements should be made consistent.

Access reform must provide pricing principles for Mutual Compensation and other rate structures that are consistent across an individual LEC's various types of interconnection arrangements, including for example, 1) long distance carrier access charges, 2) CLC interconnection, 3) independent telco interconnection, and 4) wireless interconnection. The regulators will need to consider various scenarios, including where:

- one carrier originates the call for its own customer and another carrier terminates it for the first carrier (LEC-CLC traffic today);
- one carrier originates the call for another carrier, and the second carrier terminates it (CMRS traffic today in which the called party pays);
- one carrier transports the call for its customer, but the call is originated and terminated by other carriers (transiting or long distance carrier between two other carriers).

The Commission should use access reform as an opportunity to correct the uneconomic concepts that have continued since divestiture. These uneconomic concepts include, among others, 1) recovery of non-traffic sensitive loop costs on a usage sensitive basis, rather than by increasing the SLC, and 2) providing ESPs full exemption from access charges that are paid by other service providers. The guiding principle of access reform should be that all service providers in the same geographic areas, serving similar customers should be treated consistently. Existing subsidies for

particular service providers should be removed, and new subsidies for particular providers, such as Bill and Keep for CMRS traffic, should be avoided.⁵³

Treating all providers consistently will remove uneconomic arbitrage incentives that strongly influence the use and development of networks and favor one technology over another based on regulation rather than on economic efficiency. Treating all providers consistently will allow fair competition, as all types of wireless and wireline providers increasingly compete. As markets become competitive, there is decreasing need for rate and other regulation, and the Commission and state regulators should reduce their regulation. As Commissioner Chong stated, when "full blown competition arrives," the Commission "should employ a light regulatory touch."⁵⁴ In this manner, the Commission will be furthering its goal to rely on competition wherever possible to maximize benefits to consumers and society.⁵⁵

⁵³ Where subsidies are found to be needed, e.g., potential education and healthcare services under the new Act, they should be collected in a competitively neutral manner.

⁵⁴ Separate Statement of Commissioner Rachelle B. Chong, p. 2.

⁵⁵ NPRM, para. 4.

II. COMPENSATION ARRANGEMENTS FOR INTERCONNECTED TRAFFIC
BETWEEN LECs' AND CMRS PROVIDERS' NETWORKS MUST BE JUST,
REASONABLE, AND NONDISCRIMINATORY AND MUST ALLOW
IMPLEMENTATION BY NEGOTIATING PARTIES AND THE STATES

A. COMPENSATION ARRANGEMENTS MUST ALLOW THE
OPPORTUNITY FOR COST RECOVERY

The Communications Act of 1934 mandates that rates for interstate telecommunications common carrier services be just, reasonable, and non-discriminatory.⁵⁶ The Telecommunications Act of 1996, which adds to and amends the 1934 Act, mandates the development of reciprocal compensation for termination of traffic by LECs and other telecommunication carriers.⁵⁷ The new Act does not "preclude arrangements that afford the mutual recovery of costs through the offsetting of reciprocal obligations" but allows Bill and Keep only by agreement of the parties to "waive their rights to mutual recovery."⁵⁸ Whatever means are required must be "consistent of course with meeting 'the minimal requirements for protection of investors' against confiscation that inhere in the statutory standard of just and reasonable rates."⁵⁹

The Commission would violate these requirements and this standard if, via Bill and Keep, it required an interconnection rate of zero, without any cost-recovery mechanism. This is especially true where, as in the case with LEC-CMRS

⁵⁶ 47 U.S.C. Sections 201 and 202.

⁵⁷ Section 251(b)(5).

⁵⁸ Section 252(d)(2)(B)(i).

⁵⁹ Price Caps FNPRM, para. 319 (cites removed).

interconnection, the traffic flow is severely imbalanced between the interconnecting parties. Where the traffic flow is out of balance, Bill and Keep creates costs for one interconnecting party that far exceed the costs of the other party and, thus, are not offset. Therefore, in this case Bill and Keep does not allow the just, reasonable, and non-discriminatory rates required by the Communications Act of 1934 or the reciprocal compensation requirements added by the new Act. Instead of reciprocal compensation, one party gets an abundance of free use of the other's network in exchange for allowing the other party a small amount of free use of its network.

Moreover, requiring this form of LEC interconnection solely for CMRS providers would create unreasonable discrimination in favor of terminating traffic via wireless networks. This discrimination, as outlined above, would encourage IXCs to find uneconomic arbitrage opportunities to avoid wireline access rates.

The Commission should avoid creating these serious legal and economic problems by allowing existing contractual arrangements for LEC-to-CMRS interconnection to stay in place for the duration of the contracts. This approach would allow parties to negotiate new arrangements consistent with the Communications Act of 1934 as amended by the Telecommunications Act of 1996.

1. EXISTING ARRANGEMENTS ARE REASONABLE AND ALLOW THE
OPPORTUNITY TO RECOVER COSTS

Forms Of Interconnection Arrangements

Both Pacific Bell and Nevada Bell offer CMRS providers the three forms of interconnection arrangements required by the Commission: Type 1 end office interconnection (one-way or two-way, line side or trunk side), Type 2A access tandem interconnection (one-way or two-way), and Type 2B end office interconnection (one-way mobile to land). The Commission has described these three forms as follows:

LECs are currently obligated to provide three basic types of interconnection to CMRS providers. Type 1 service involves interconnection to a telephone company end office similar to that provided by a local exchange carrier to a private branch exchange (PBX). Type 1 interconnection involves an end office connection that combines features of line-side and trunk-side connections and uses trunk-side signalling protocols. Type 1 interconnections enable the CMRS provider to access any working telephone number, including all NXX codes within the LATA of the LEC providing the interconnection. The Type 1 connection also permits access to Directory Assistance, N11 codes, and service access codes. Type 2A connections give the CMRS carrier the ability to connect to the Public Switched Network in the same manner as any wireline carrier. The connections, which may be either solely to access tandems or to a combination of tandems and other central offices, are true trunk-side connections using trunk-side signalling protocols. Type 2A connections do not permit access to LEC operator services or N11 codes. Type 2B connections are trunk-side connections to an end office that operate in the same manner as high-usage trunks. Under Type 2B interconnection, the CMRS provider's primary traffic route is

the Type 2B connection, with any overflow traffic routed through a Type 2A connection. Type 2B interconnection permits access to valid NXX codes, but cannot access operator services or N11 codes.⁶⁰

In addition to offering the three interconnection arrangements described above, Pacific Bell offers Type 2A0SS operator services tandem interconnection.

The Commission supported the three types of interconnection arrangements because they were requested by CMRS providers.⁶¹ We have negotiated the terms of these arrangements in good faith. No complaints have been filed against us concerning these arrangements before either this Commission or the state commissions.

Pacific Bell has established contracts in its territory with the cellular providers for their MSAs and RSAs, with the certificated paging and mobile carriers, with an ESMR, and with Pacific Bell Mobile Services for its two PCS MTAs. We currently are negotiating with two other PCS license holders.

Pacific Bell's interconnection service descriptions, as well as rate structures and rates from our model contract for CMRS provider interconnection, are attached hereto as Exhibit C. Pacific Bell filed its contract arrangements at the CPUC as a proposed

⁶⁰ Equal Access and Interconnection Obligations Pertaining to Commercial Mobile Radio Services, CC Docket No. 94-54, Notice of Proposed Rule Making and Notice of Inquiry, released July 1, 1994 ("CMRS Equal Access Order"), para. 105, citing See generally The Need to Promote Competition and Efficient Use of Spectrum for Radio Common Carrier Services, Memorandum Opinion and Order, 4 FCC Rcd 2369, 2377, n. 16 (1989) (Cellular Interconnection Order), aff'g Interconnection Order, 2 FCC Rcd 2910 (1987) (Commission adopted policy statement rather than specific rules because of existence of a variety of interconnection arrangements and system designs). Cf. CMRS Second Report, 9 FCC Rcd at 1498.

⁶¹ See CMRS Equal Access Order, para. 103.

tariff, and in compliance with the CPUC's requirements subsequently refiled the proposed tariff on September 1, 1994 in the CPUC's Open Access Proceeding,⁶² where the CPUC has not yet addressed them.

Nevada Bell has tariffed its interconnection arrangements at the Nevada Public Service Commission. Nevada Bell's tariffs are attached hereto as Exhibit E.

In the process of good faith negotiations, our interconnection arrangements have been tailored to meet the requests of CMRS providers. For instance, as discussed above in Part I, with our most popular interconnection arrangement (Type 2A) CMRS providers requested special end user pricing to make their service more attractive. With that pricing, our end users can call CMRS end users anywhere in a LATA at local service rates, including flat-rate basic exchange service rates, rather than toll rates. We agreed to this rate structure as part of the overall interconnection package in which we make up the shortfall from end users for calls that exceed the local calling areas in our charges to the CMRS providers. The package meets embedded cost recovery principles of the CPUC, including recovery of appropriate shared and common costs. Therefore, changes in our rate structure and rates for CMRS providers must not be made in isolation, but with reference to the overall package which includes end user charges, in order to retain a reasonable opportunity to recover costs.

⁶² Rulemaking on the Commission's Own Motion to Govern Open Access to Bottleneck Services and Establish a Framework for Network Architecture Development of Dominant Carrier Networks, R.93-04-003.

Flow Of Traffic

The Commission requests comments concerning the flow of traffic over the LEC's interconnection arrangements.⁶³ There is an extreme imbalance of traffic flowing between CMRS and LEC providers. Our records indicate an approximately 83% mobile-to-land traffic distribution. PCS forecasted traffic flows suggest that PCS will start with approximately 80% mobile-to-land traffic distribution.

The current cellular imbalance is heavily influenced by the way that wireless carriers recover their costs and the prices they charge their end users. They charge the mobile subscriber for airtime on both terminating and originating calls. Since the cellular subscriber is charged for airtime on calls received ("Called Party Pays"), cellular subscribers often reduce their costs by turning off their sets and not giving out their cellular phone numbers. This policy may discourage economic efficiency since networks may not be fully used. Nonetheless, the practice has been very profitable for cellular providers, and PCS providers may also charge their end users for originating and terminating traffic.

The existing rates for a cellular call, averaging close to 45 cents per minute, far exceed traditional land-to-land based rates, and when cellular providers apply monthly charges they average approximately \$45.00, versus our \$11.25 flat-rate local service. Interconnection charges are a relatively small component of the price of cellular service. LEC termination charges clearly are not affecting the balance of traffic, since the vast majority of wireless calls are terminated on the LECs' networks.

⁶³ NPRM, para. 41.

It is unlikely that a change to "Sender Pays," which is also known as "Calling Party Pays," would improve the imbalance of traffic.⁶⁴ On the one hand, CMRS subscribers probably would be more inclined to encourage landline customers to call them, if the CMRS subscribers did not have to pay for the calls. On the other hand, the landline customers would be less inclined to make the calls if they had to pay the relatively high CMRS airtime rates. It also should be noted that "Calling Party Pays," as viewed by some CMRS providers, probably would not help resolve the LECs' cost recovery problems. Some CMRS providers have indicated that they would want full compensation for airtime from the calling party, in addition to compensation from the LEC for terminating the call.

As mobile phones become more of a mass market substitute for landline phones, the traffic flow may become more balanced. For now, wireless is a limited substitute for mass market landline services.⁶⁵ Because it offers mobility, cellular service commands a premium price, and attracts the most affluent customers. For instance, cellular service is the keystone of AT&T's strategy to skim the profit in the local exchange. AT&T has offered to send select customers cellular pocketphones for a dollar, and

⁶⁴ The CPUC has decided against this payment option at the present time because of concern for a potential unfair impact on the landline subscriber who may not know that the call is being routed to a cellular phone at rates that far exceed those for landline service. The CPUC has indicated that it is agreeable to receiving data from either wireless or landline carriers that would support Calling Party Pays.

⁶⁵ Wireless is still considered by the CPUC as a discretionary service and is not a component of universal service. CPUC Decision 90-06-025, supra n.3, Ordering paragraph 1.

through its "True Reach" promotion combines discounts on long-distance and cellular calling.⁶⁶

Widespread entry by the PCS providers will, of course, expand capacity and place downward pressure on rates. A balanced traffic flow, however, is unlikely to come to pass within the next five to ten years. Professor Hausman concludes, "I expect significantly more calls to terminate on the landline network for the foreseeable future."⁶⁷ The continuing imbalance of traffic will ensure that the proposed Bill and Keep remains a bad interim solution for all the reasons that we discussed above in our General Comments in Part I and that we discuss below in subsection 3 of this part.

Interstate And Intrastate Traffic

The Commission requested comments on the jurisdictional breakdown of traffic flowing over our CMRS interconnection arrangements.⁶⁸ The vast majority of traffic involved in our arrangements is intrastate in nature. Our major metropolitan areas in California, where cellular service is predominantly used, are far from the state boundaries. The traffic that we carry that has been identified as interstate involves an IXC that declares a PIU. CMRS providers have not informed us of any interstate traffic carried without use of an IXC. Our volumes of traffic involving CMRS interconnection during 1995 were 90.3% intrastate and 9.7% interstate.

⁶⁶ See "AT&T Eagerly Plots A Strategy To Gobble Local Phone Business," Wall Street Journal, August 21, 1995, p. A1.

⁶⁷ Hausman Statement, para. 28, attached hereto as Exhibit B.

⁶⁸ NPRM, para. 41.

The Commission's Current Interstate Mutual Compensation Requirement

The Commission seeks comments on the extent to which its Mutual Compensation requirement is not being observed in the marketplace.⁶⁹ The Commission required Mutual Compensation under the following circumstances:

- The Commission's Mutual Compensation policy relates to the costs of interstate switching.⁷⁰ It does not relate to intrastate traffic.
- The Commission's Mutual Compensation policy allows the landline or the cellular carrier to recover "its actual cost of switching traffic for the other carrier."⁷¹ In other words, each must independently establish its costs related to interstate switching.

These principles were clearly stated. They were extended but not expanded with respect to CMRS generally.⁷²

As we discussed above, the calls that we carry involving CMRS traffic that have been identified to us as interstate involve an IXC. Interstate calls that are originated by a mobile customer and are carried by an IXC are handled in one of two ways. Either the call goes directly to an IXC or it comes to us and we switch it to an IXC. In the first case, the traffic does not go over our network. In the second case, the IXC compensates us for our interstate switching costs, and we do not charge the CMRS provider. If we are receiving an interstate call and handing it off to a CMRS provider,

⁶⁹ Id.

⁷⁰ The Need to Promote Competition and Efficient Use of Spectrum for Radio Common Carrier Services, Memorandum Opinion and Order, 4 FCC Rcd 2369, para. 25 (1989).

⁷¹ Id. at para. 20.

⁷² Second CMRS Report and Order, 9 FCC Rcd 1411, 1498, citing

again the IXC compensates us through the local transport rate element only of interstate access charges, and we do not assess an interconnection charge on the CMRS provider. Since CMRS providers are not compensating us with respect to calls that are identified to us as interstate, our compensation to CMRS providers on these calls would be inappropriate and contrary to the principles of Mutual Compensation.

For CMRS interconnection that does not involve an IXC, as discussed above in our General Comments in Part I and below in subsection 3 of this part, we intend to start renegotiating contracts based on Mutual Compensation in April.⁷³

⁷³ See Exhibit A hereto for Pacific Bell's letters to CMRS providers concerning this renegotiation.

2. GENERAL PRICING PRINCIPLES SHOULD BE APPLIED IN A MANNER THAT PROVIDES THE OPPORTUNITY TO RECOVER TOTAL COSTS IN A MARKET WHERE COMPETITION IS RAPIDLY INCREASING

Rate Structure

The Commission states that it believes that "costs should be recovered in a manner that reflects the way they are incurred."⁷⁴ We generally agree, but the Commission should be careful not to try to mandate strict rules in this area where flexible negotiation between the parties is essential. For instance, because CMRS providers requested it, Pacific Bell offers a tandem 2A blended arrangement in which the usage rate includes recovery of the cost of the dedicated, digital facility. Thus, the usage rate is higher than the rate for usage charged when a separate, dedicated 1.544 High Capacity facility is billed separately at a flat rate. The higher usage rate is needed in order to provide for the recovery of costs of that facility and the substantial costs of tandem switching and common transport. As we begin renegotiating the contracts in April based on Mutual Compensation concepts, we intend to move to flat rate pricing for the dedicated facilities. But we must also respect the positions of the CMRS providers with whom we will be negotiating concerning the timing and details of this change.

Another example of the need to be flexible and careful in this area of cost recovery is peak-load pricing to recover volume-sensitive (e.g., switching) costs, about

⁷⁴ NPRM, para. 42.

which the Commission also seeks comments.⁷⁵ As the Commission acknowledges, charging different prices at different times of day can cause customers to shift their calling to less expensive times of day and create new peak periods.⁷⁶ In our past negotiations, CMRS providers have not been interested in peak-load pricing, but we intend to remain flexible in future negotiations.

The Commission points out that “[t]here are also certain shared facilities, such as land, buildings, and telephone poles, whose costs do not vary with capacity (or peak period traffic volumes).”⁷⁷ The Commission seeks comment on “whether they should be recovered entirely through peak rate charges, or through off-peak rates as well.”⁷⁸ The recovery of these shared and common costs should not be limited to peak rate charges. These are costs that carriers incur regardless of the volume of traffic. Carriers must operate twenty four hours a day and incur costs all the time. Customers should not be encouraged to escape payment of these costs by placing calls at off-peak periods. In any event, recovery of these costs requires pricing flexibility, free of regulatory restraints, including dictates on what time of day to collect them. As we discuss below, it is essential that carriers, like other businesses, be allowed the opportunity to recover their shared and common costs. Recovery of those costs is not a luxury. It is essential to staying in business.⁷⁹

⁷⁵ Id. at paras. 45-46.

⁷⁶ Id. at para. 45.

⁷⁷ Id. at para. 46.

⁷⁸ Id.

⁷⁹ Hausman Statement, para. 12, attached hereto as Exhibit B.

Finally, the Commission “note[s] that a carrier may incur varying costs to provide a given service in different geographic areas” and seeks “comment on how this should be taken into account.”⁸⁰ Carriers do indeed incur varying costs in different geographic areas. In metropolitan areas, traffic is more dense and the costs per-unit of traffic are lower than in other areas. The Commission recognized this in the Expanded Interconnection proceeding where it established zone density pricing in order to provide relief from the study-area-wide price averaging requirements which “force the LECs to price above cost in the urban areas where competition is most intense....”⁸¹ The Commission pointed out that “[f]ailure to change the current system of uneconomic rate averaging would seriously constrain access competition and potentially deprive customers of the attendant benefits.”⁸²

Although the Expanded Interconnection proceeding dealt with special access and switched transport costs, switching costs have similar cost characteristics. As NECA showed in its comments in CC Docket No. 80-286, “switching costs per unit of demand increase as switch size decreases.... Rural areas in fact lack the economies of scope and scale that characterize urban, high-density areas and this results in higher switching costs.”⁸³ Loops also are longer, and therefore higher cost, in low-density areas than in high-density areas.⁸⁴

⁸⁰ NPRM, para. 46.

⁸¹ Expanded Interconnection with Local Telephone Company Facilities, CC Docket No. 91-141, Transport, Phase I, Second NPRM, para. 32.

⁸² Expanded Interconnection with Local Telephone Companies, 7 FCC Rcd 7369, para. 184 (1992) (“Special Access Expanded Interconnection Order”).

⁸³ Comments of NECA, CC Docket No 80-286, filed October 10, 1995, p. 30.

⁸⁴ See Reply Comments of Pacific Bell and Nevada Bell, p. 9, filed January 10, 1996, Price Cap Performance Review for Local Exchange Carriers.

LECs need the flexibility to price interconnection and termination at different prices in different geographic areas. CAPs and CLCs will provide these services to CMRS providers without concern for statewide rate averaging. What the Commission found regarding special access and switched transport is true for interconnection and termination. The Commission acknowledged that preventing the LECs from pricing at cost will “give the new entrants false economic signals” by “creat[ing] a pricing umbrella for the CAPS.” The Commission found that this, in turn, could “undermine efficiency by preventing the LECs from competing effectively even when they are the low cost service provider” and “deprive customers of the benefits of more vigorous competition.”⁸⁵ The Commission stated that this may “increase [the LECs] competitive losses..., bringing upward pressure to bear on LEC rates for less competitive services, including those used by residential customers.”⁸⁶

Rate Levels

The Commission points out, “economists generally agree that prices based on LRIC reflect the true economic cost of a service and give appropriate signals to producers and consumers and ensure efficient entry and utilization of the telecommunications infrastructure.”⁸⁷ The Commission also explains, “[G]iven that services are provided over shared facilities and there are economies of scale and scope, setting the price of each discrete service based on the LRIC of that service will

⁸⁵ Special Access Expanded Interconnection Order, paras. 172 and 178.

⁸⁶ Id. at paras. 177 and 178.

⁸⁷ NPRM, para. 47.

not recover the total costs of the network.”⁸⁸ The Commission's observations are absolutely correct, and consistent with Professor Hausman's analysis and that of Drs. Tardiff and Emmerson.⁸⁹ For these reasons, Drs. Tardiff and Emmerson state that LRIC should be used for price floors.⁹⁰

The Commission is describing a dilemma that all competitive firms face: how to recover their total firm costs (some of which are not allocable to any one product or service) while competition drives the prices of their products or services toward incremental costs. The way that a firm resolves this dilemma is, literally, its secret for remaining in business. In competitive markets, multi-service firms typically recover the difference between incremental costs and the total costs of producing all services by pricing according to the differences in demand elasticities between the services. Services with less elastic demand are priced to produce higher margins, that is, to contribute more to the firm's total costs. AT&T, for example, said in its 1993 annual report:

In the latter half of 1993 we raised some of our prices and fees -- about \$500 million on an annual basis. These increases were primarily for services where customer demand is not very sensitive to price.

The maxim that competition drives the prices of products toward economic cost is frequently misunderstood. The notion that competition necessarily drives all prices

⁸⁸ Id. at para. 48.

⁸⁹ Hausman Statement, para. 12, attached hereto as Exhibit B; Tardiff and Emmerson, pp. 4, 5, and 7, attached hereto as Exhibit D.

⁹⁰ Id. at 4.

down to (rather than simply “toward”) economic cost is simply wrong. As Drs. William J. Baumol and J. Gregory Sidak write,

Economic efficiency requires the price of every product to be set equal to its marginal cost, provided that doing so is consistent with the economic viability of the firm, [but only in] the absence of scale economies.

[I]f the firm's production process is subject to economies of scale, then the requirement that prices be set equal to marginal costs is a recipe for bankruptcy. Under economies of scale, the revenues yielded by marginal-cost pricing will necessarily fall short of the total costs of the firm's outputs.

Thus, no regulator can be expected to follow the precept of marginal-cost pricing that is integral to the model of perfect competition, for to do so would either drive the regulated firm into bankruptcy or force government permanently to subsidize the resulting deficit only at the expense of consumers, who must forgo the savings from the scale economies that would have been passed along through lower prices.⁹¹

Price cap regulation was intended to facilitate efficient entry by others, and let LECs prepare for competition themselves, by allowing a limited amount of demand-based pricing (as competitive firms do), via Ramsey pricing.⁹²

In the instant proceeding on wireless interconnection, the Commission proposes to break with these sound economic principles of allowing LECs some flexibility to determine prices above LRIC based on marketplace demand. The excuse provided is an old one -- LEC market power⁹³ -- but the response is new. Rather than tying LEC

⁹¹ Toward Competition in Local Telephony (MIT Press, 1994), pp. 33-35 (emphasis added). Dr. Baumol frequently has testified for AT&T, so he can hardly be accused of favoritism toward the LECs.

⁹² See Price Caps Further Notice, 3 FCC Rcd at 3257; National Rural Telecom Ass'n v. FCC, 988 F.2d 174, 182 (D.C. Cir. 1993).

⁹³ NPRM, paras. 2, 11-13.

prices to a fully distributed cost scheme that created severe harm by keeping prices in high-density areas far above LRIC, the Commission now proposes to tie one group of prices, interconnection and termination, to a theory of Bill and Keep that allows no compensation. This new response is both economically and legally unsound. Moreover, the old excuse of LEC market power does not fit the new era in telecommunications that elsewhere the Commission is beginning to recognize.

The Rapid Erosion Of Market Power

The Commission has correctly concluded that a consideration of market power is based primarily on supply and demand elasticities rather than current market share.⁹⁴ These elasticities show that basing regulatory policy on LEC market power is a huge mistake. The competitive supply of telecommunications alternatives that can be made quickly available is practically limitless, and any unreasonably high pricing by LECs will drive customers, including CMRS providers, to that alternative supply.⁹⁵

We reached an historic agreement that included our selling of unbundled links to MFS beginning on April 1, 1996 (and we will offer interconnection agreements with unbundled links on the same terms to any other provider). Under this agreement, end user customers need not come to us for either loops or switching. The first competitor

⁹⁴ Price Cap Performance Review for Local Exchange Carrier, CC Docket No. 94-1, Second Further Notice of Proposed Rulemaking, paras. 132-146, released September 20, 1995.

⁹⁵ See Hausman Statement, para. 11.

to buy unbundled loops, MFS, will control the customer, and may transport all traffic to its own switch thanks to collocation.

The supply of competitors' local service switches is large and growing rapidly. AT&T has installed 880 communications "nodes" (the equivalent of Class 5 switches) nationwide, an average of five for each LATA, subtending 72 larger "tandem" switches.⁹⁶ It will serve the crown jewel of our wire centers in San Francisco -- SF01 -- and the rest of California with multiple 5ESS switches. TCG and MFS have ATM switches in San Francisco; Brooks Fiber plans to install one in San Francisco in mid-1996; Intelcom Group ("ICG") has one in Oakland. Similarly, the California Cable Television Association has said that its members will invest \$8 billion in the next two to three years to expand telephone networks in California, and that they will provide up to 70% of Californians with competitive local service sometime in 1997.⁹⁷ ALTS, just one of our competitors' trade associations, has said that its members have 500 networks operational or under construction, serving more than 600 communities (and more than 9,000 buildings), and have total 1995 revenues exceeding \$1.2 billion. ALTS projects total "competitive industry" revenues to increase sixteen fold to \$20.3 billion in 1998. More than one hundred competitive switches are expected to be operational by the end

⁹⁶ "AT&T Eagerly Plots A Strategy To Gobble Local Phone Business," Wall Street Journal, August 21, 1995, p. A1. See also John J. Keller, "AT&T Vows Battle to Offer Local Service," Wall St. J., Oct. 27, 1995, p. A3, in which AT&T Chairman Robert Allen was quoted as saying, "We will fight for the right to give our customers a choice for local service through every option open to us. That includes reselling local services, using alternative providers and building our own telephone-network facilities."

⁹⁷ "Pac. Bell To Seek Compensation," Dow Jones/News Retrieval Company News, July 24, 1995.